STATE OF ILLINOIS

OFFICE OF THE AUDITOR GENERAL

REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

For the Year Ended June 30, 2010

WILLIAM G. HOLLAND

AUDITOR GENERAL

STATE OF ILLINOIS
COMPREHENSIVE ANNUAL FINANCIAL REPORT
FINANCIAL AUDIT
For the Year Ended June 30, 2010

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The annual financial statements of the State of Illinois for the year ended June 30, 2010 were issued under a separate cover.

STATE OF ILLINOIS
COMPREHENSIVE ANNUAL FINANCIAL REPORT
FINANCIAL AUDIT
For the Year Ended June 30, 2010

STATE OFFICIALS

Governor	Patrick Quinn
Comptroller (January 10, 2011 to Present)	Judy Baar Topinka
Comptroller (through January 9, 2011)	Daniel W. Hynes
Treasurer (January 10, 2011 to Present)	Dan Rutherford
Treasurer (through January 9, 2011)	Alexi Giannoulias
Speaker of the House	Michael J. Madigan
President of the Senate	John J. Cullerton

SUMMARY

The audit of the State of Illinois' financial statements was performed in accordance with *Government Auditing Standards*. This report is an integral part of that audit.

SUMMARY OF FINDINGS

Number of	Current Report	Prior Report
Findings	8	4
Repeated findings	4	2
Prior recommendations implemented or not repeated	0	1

SCHEDULE OF FINDINGS

Item No.	Page	Description	Finding Type
		FINDINGS (*GOVERNMENT AUDITING STANDARDS*)	
10-1	7	Inadequate Financial Reporting Process	Material Weakness
10-2	11	Financial Reporting Weaknesses	Material Weakness
10-3	16	Late Payment of Statutorily Mandated Transfers	Noncompliance
10-4	18	Noncompliance with General Obligation Financing Provisions	Noncompliance
10-5	20	Weaknesses Identified in the Securities Lending Program	Noncompliance
10-6	23	Debt Covenant Violation	Noncompliance
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10-8	29	Weaknesses in Compilation Process	Material Weakness

EXIT CONFERENCE

An exit conference was held with the Governor's Office of Management and Budget's personnel on July 6, 2011. Those attending were:

Governor's Office of Management and Budget

Julie O'Brien, Associate Director
Thomas Mikrut, Associate General Counsel

Office of the Auditor General

Georgine Stephens, Assistant Director
Terri Davis, Audit Manager

Both the Office of the Comptroller and the Office of the Treasurer declined a formal exit conference.

AGENCY RESPONSES

Responses to findings and recommendations were provided as follows:

Mr. Jack Lavin, Chief of Staff, Office of the Governor on July 15, 2011.

Ms. Kathleen Madonia, Acting Financial Reporting Director, Office of the Comptroller on July 13, 2011.

Ms. Barb Ringler, Chief Internal Auditor, Office of the Treasurer on July 11, 2011.

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OFFICE OF THE AUDITOR GENERAL
WILLIAM G. HOLLAND

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

Honorable Michael J. Madigan, Speaker of the House
Honorable John J. Cullerton, President of the Senate
Members of the General Assembly
Honorable Patrick Quinn, Governor
Honorable Judy Baar Topinka, Comptroller

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Illinois as of and for the year ended June 30, 2010 as listed in the Table of Contents for Section II of the Illinois Comprehensive Annual Financial Report, which collectively comprise the State of Illinois' basic financial statements and we have issued our report thereon dated June 30, 2011. Our report was modified to include a reference to other auditors and included an explanatory paragraph which stated that as discussed in note 2, the financial statements have been restated as of July 1, 2009 for prior year reporting errors. Our report also included an explanatory paragraph which stated "The deficit for net assets of the governmental activities in fiscal year 2010 continued to increase by $8,399,121,000 from $29,461,762,000 at June 30, 2009 to $37,860,883,000 at June 30, 2010. This deficit, which is presented on an accrual basis, is the excess of total liabilities over total assets and represents a deferral of current and prior year costs to future periods. Also, as discussed in Note 22 to the basic financial statements: 1) the State issued additional debt subsequent to June 30, 2010; and 2) initiated a cash flow borrowing and general funds liquidity program involving transfers from various public funds". We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. For purposes of this report, our consideration of internal control over financial reporting and our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, and other matters did not include the State's discretely presented component units. Separate reports have been issued for these entities. The findings, if any, included in those reports are not included herein.

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Internal Control Over Financial Reporting

In planning and performing our audit, we considered the State of Illinois' internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements and not for the purpose of expressing an opinion on the effectiveness of the State of Illinois' internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the State of Illinois' internal control over financial reporting.

Our consideration of the internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in the internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses.

A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiencies described in findings 10-1, 10-2, 10-7 and 10-8 in the accompanying schedule of findings and responses to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State of Illinois' financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying schedule of findings and responses as findings 10-3, 10-4, 10-5 and 10-6.

The Office of the Governor's, the Office of the State Comptroller's, and the Office of the Treasurer's responses to the findings identified in our audit are described in the accompanying schedule of findings. We did not audit these responses and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of the Auditor General, the General Assembly, the Legislative Audit Commission, the Governor, the Comptroller, the State's Management and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

WILLIAM G. HOLLAND	BRUCE L. BULLARD, CPA
Auditor General	Director of Financial and Compliance Audits
State of Illinois	Office of the Auditor General

Springfield, Illinois
June 30, 2011

10-1. **FINDING** (Inadequate Financial Reporting Process)

The State of Illinois' current financial reporting process does not allow the State to prepare a complete and accurate Comprehensive Annual Financial Report (CAFR) or the Schedule of Expenditures of Federal Awards (SEFA) in a timely manner. Reporting issues at various individual agencies caused delays in finalizing the financial statements, which did not occur until June of the subsequent year for the past four fiscal years. See also finding 10-2 for additional detail. The lack of timely financial reporting limits effective oversight of State finances, adversely affects the State's bond rating, and jeopardizes federal funding.

Accurate and timely financial reporting problems continue to exist even though the auditors have: 1) continuously reported numerous findings on the internal controls (material weaknesses and significant deficiencies), 2) commented on the inadequacy of the financial reporting process of the State, and 3) regularly proposed adjustments to financial statements year after year. These findings have been directed primarily toward the Office of the Comptroller (IOC) and major State agencies under the organizational structure of the Office of the Governor.

The State has not solved these problems or made substantive changes to the system to effectively remediate these financial reporting weaknesses. The process is overly dependent on the post audit program being a part of the internal control for financial reporting even though the Illinois Office of the Auditor General has repeatedly informed State agency officials that the post audit function **is not and should not** be an internal control mechanism for any operational activity related to financial reporting.

The State of Illinois has a highly decentralized financial reporting process. The system requires State agencies to prepare a series of complicated financial reporting forms (SCO forms) designed by the Office of the State Comptroller to prepare the CAFR. For the most part, these SCO forms are completed for each of the State's 864 primary government/fiduciary funds and 26 component units. The forms are completed by accounting personnel within each State agency who have varying levels of knowledge, experience, and understanding of generally accepted accounting principles (GAAP) and of the State's accounting policies and procedures. Agency personnel involved with this process are not under the organizational control or jurisdiction of the IOC. Further, these agency personnel may lack the qualifications, time, support, and training necessary to timely and accurately report year end accounting information to assist the IOC in the preparation of the statewide financial statements in accordance with GAAP.

Although these SCO forms are subject to review by the IOC financial reporting staff during the CAFR preparation process, audit adjustments and significant internal control deficiencies relative to the financial statements have been identified during the last nine audits of the CAFR. Additionally, beginning balances related to the primary government have been restated for 7 of the last 9 years.

The Illinois Office of the Auditor General released a management audit in February 2011 that further assessed the State's financial reporting systems. The survey of 88 of 90 primary units of government revealed that 263 different financial reporting systems are used by primary government agencies. Furthermore, the agencies reported that only 16 percent of these financial reporting systems are compliant with GAAP, which drastically increases the amount of time spent by agencies during the year-end GAAP conversion process. In addition, fifty-three percent of the financial reporting systems are not interrelated which consequently requires manual intervention to convert data increasing the likelihood of errors and causing further reporting delays.

Although the deficiencies relative to the CAFR and SEFA financial reporting processes have been reported by the auditors for a number of years, problems continue with the State's ability to provide accurate and timely external financial reporting. Corrective action necessary to remediate these deficiencies continues to be problematic.

Concepts Statement of the Governmental Accounting Standards Board (GASBCS 1, paragraph 66) states, "if financial reports are to be useful, they must be issued soon enough after the reported events to affect decisions."

According to OMB Circular A-133 § .300(d) and (e), a recipient of Federal awards is required to prepare appropriate financial statements, including the Schedule of Expenditures of Federal Awards and to ensure that audits required by this part are properly performed and submitted when due. Additionally, the A-102 Common Rule requires that non-Federal entities receiving Federal awards establish and maintain internal control designed to reasonably ensure compliance with Federal laws, regulations, and program compliance requirements.

In discussing this condition with the Office of the Governor, they stated that the lack of an enterprise accounting system – there are over 100 separate decentralized agency financial systems in the State – results in widely varied controls rather than a uniform set of controls to carry out the accounting policy set by the Office of the State Comptroller. The decentralized nature of the State's accounting systems and lack of a general ledger system results in time consuming, manual tabulations by accounting personnel who lack the qualifications and systems to report accurate financial information on a timely basis.

In discussing these conditions with IOC management, the indicated delays were caused, in part, by inaccurate data being submitted by some agencies. GAAP packages with inaccurate data cause delays in the audit process which in turn causes delays in releasing the final reports.

Failure to establish effective internal controls at all State agencies regarding financial reporting for the preparation of the CAFR and the SEFA prevents the State from completing an audit in accordance with timelines set forth in OMB Circular A-133, which may result in the suspension of Federal funding. Delays in financial reporting decrease the usefulness of such information. (Finding Code No. 10-1, 09-2, 08-2, 07-2)

RECOMMENDATION

We recommend the Office of the Governor and the Office of the State Comptroller work together to resolve the State's inability to produce timely and accurate GAAP basis financial information and a Statewide SEFA.

AGENCY RESPONSES

Office of the Governor:

The Governor's Office agrees with this finding. The State has been working with the Senate Committee on State Government and Veterans Affairs to solve some of these problems, although without adequate funding, correcting this will be difficult. The Governor's Office, the Governor's Office of Management and Budget (GOMB) and the Office of the Comptroller have developed a timeline for short-term, mid-term and long-range plans. In the short term, GOMB is taking steps to ensure that agencies under the Governor provide timely financial information to the Comptroller. A letter is going out to all agencies to emphasize the importance to the Governor of timely and accurate reporting. In addition, job descriptions are being developed by the Department of Central Management Services to allow agencies to hire employees skilled in financial statement preparation. This is a complicated and lengthy process that is expected to be completed by the end of 2011. Legislation has been proposed to make changes in personnel policy to facilitate hiring such qualified individuals. The next phase of this process is to develop a business plan to present to the legislature. The business plan will provide the outline for procuring and implementing a statewide financial accounting system. GOMB and the Governor's Office will be primarily responsible for developing such a plan, with input from a steering committee. The steering committee is comprised of the chief information officer, members of the General Assembly as well as representatives of GOMB, the Comptroller's Office and several operating agencies. The steering committee is scheduled to meet on July 20, 2011. Ideally, the business plan will be submitted to the Senate Committee on State Government and Veterans Affairs for review during the fall veto session. Based on the business plan, the legislature will need to provide capital funding for the statewide financial accounting system. Once funding is secured, an RFP will be issued seeking proposals for software that meets the State's requirements. The total implementation process is expected to take several years and internal control issues will persist until this is complete. Until this is completed, we will continue working with the agencies to provide complete information, given the State's current capacities.

Office of the Comptroller:

The IOC will assist the Governor's Office in their efforts to increase the quality of the GAAP packages by providing training and technical assistance to State Agencies.

10-2. **FINDING** (Financial Reporting Weaknesses)

The State of Illinois did not have adequate controls to assess the risk that information reported by individual agencies of the primary government would not be fairly stated and compliant with generally accepted accounting principles. As reported in Finding 10-1 the State has a decentralized financial reporting process. Primarily in response to this decentralized process, we perform audits at 26 agencies of the primary government, including the five pension systems and the State Board of Investments. During these audits, we noted deficiencies that were either material weaknesses or significant deficiencies related to the internal controls over the financial reporting process.

A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

The chart below summarizes the number of material weaknesses and significant deficiencies we reported for each agency.

Agency	Material Weaknesses	Significant Deficiencies	Combined Total
Treasurer (Fiscal Officer Responsibilities)	1	1	2
Central Management Services	1	2	3
Children & Family Services	1	0	1
Department of Natural Resources	0	1	1
Department of Corrections	4	3	7
Employment Security	0	1	1
Department of Human Services	1	3	4
Healthcare and Family Services	1	1	2
Department of Revenue	1	11	12
Department of Transportation	2	3	5
Capital Development Board	1	0	1
Gaming Board	1	0	1
Illinois Student Assistance Commission	1	4	5
Total	15	30	45

Details of each material weakness and significant deficiency are reported in each of the agency's financial audit for the year ended June 30, 2010 (reports are available on the Auditor General's web-site). Material weaknesses and significant deficiencies further extend financial reporting timelines since additional measurements and reporting is required. Completion or substantial completion of these audits is necessary in order for the Auditor General to issue an opinion on the State's basic financial statements.

In addition to the deficiencies noted above, we identified two material errors during our audit of the State Comptroller's compilation process. Summary information regarding these errors is provided below.

Restatements – Correction of Errors

The financial statements of the primary government have been restated as of July 1, 2009 for the following errors:

Description of Error	**Amount (in thousands)**	**Responsible Agency**
Overstatement of accounts payable in the General Fund	$524,937	Department of Healthcare and Family Services
Understatement of unavailable revenue relating to estate taxes receivable in the General Fund	$265,768	Office of State Treasurer and the Office of the Comptroller
Understatement of net amounts due to component units for ongoing construction contracts in the Road Fund	$58,002	Department of Transportation
Overstatement of capital assets for temporary easements which expired in previous fiscal years	$25,959	Department of Transportation

Misstatements Identified During the Audit Process

In addition to the restatements described above, the following chart indicates adjustments identified during our audits.

Opinion Unit	Amount (in thousands)*	Responsible Agency
Governmental Activities	$127,882	Department of Central Management Services
Governmental Activities	$38,494	Department of Human Services
Governmental Activities	$35,684	Department of Healthcare and Family Services
Governmental Activities	$32,178	Department of Revenue
Governmental Activities	$3,466,000**	Office of the Comptroller
Governmental Activities	$37,847	Department of Corrections
Business-type Activities	$15,780	Illinois Student Assistance Commission
General Fund	$51,153	Department Central Management Services
General Fund	$38,456	Department of Human Services
General Fund	$35,903	Department of Healthcare and Family Services
General Fund	$25,018	Department of Revenue
General Fund	$20,000	Department of Transportation
General Fund	$37,847	Department of Corrections
Road Fund	$12,788	Department of Central Management Services
Road Fund	$20,000	Department of Transportation
Aggregate Remaining Fund Information	$15,634	Illinois Student Assistance Commission
Aggregate Remaining Fund Information	$63,941	Department of Central Management Services
Aggregate Remaining Fund Information	$3,466,000**	Office of the Comptroller

* *Amounts resulted in one adjustment or a series of adjustments for the opinion unit. The dollar amount reported is the largest account type adjusted.*

** *Reclassification adjustment to appropriately allocate to functional expenses.*

During our audit, we also noted several other errors in the preparation of the Comprehensive Annual Financial Report (CAFR) including amounts not agreeing between statements and/or footnotes, typographical errors, and incorrect account classification. In addition, the Office of the Comptroller did not provide sufficient guidance to agencies regarding the proper accounting for held payments associated with inadequate cash availability.

Organizational Deficiencies

The State's decentralized reporting system and related decentralized internal control system is not adequate to reduce the likelihood that a material misstatement of the State's financial statements could occur and not be detected during the normal course of business. The following are descriptions of deficiencies that were noted during our audits at various agencies and the Office of the Comptroller (IOC).

- Audit adjustments were routinely identified for the primary government's State agencies required to prepare financial statements that were not deemed material by agency management and were not posted to the financial statements. In working with the IOC to finalize the State's financial statements, it is necessary to accumulate all of the uncorrected adjustments and evaluate these adjustments in total to ensure that they do not materially misstate the statewide financial statements. Because of the volume of these passed adjustments, there is a continual risk that the State's financial statements may be materially misstated until this accumulation and evaluation process is completed. In addition, these uncorrected adjustments require continued accumulation and evaluation in subsequent years.

- Those charged with governance are not actively involved in the financial reporting process. Specifically, those charged with governance do not have a formal process for establishing financial reporting target completion dates and routinely monitoring progress towards meeting completion dates. However, we did note significant improvement at the Office of the Comptroller beginning in late January 2011.

In discussing this condition with the Office of the Governor, they stated that the weakness is due to separation in the responsibility for the State's internal control procedures among agencies and component units. The IOC has the statutory authority to develop and prescribe accounting policy for the State but the State lacks an enterprise accounting system to capture all items necessary to provide underlying support to review agency financial transactions. In addition, there is a shortage of qualified individuals in the State to ensure that all transactions are recorded in accordance with governmental accounting standards.

In discussing these conditions with IOC management, they stated Misstatements were caused by a separation in the responsibility for the State's financial reporting. The IOC has the statutory authority to develop and prescribe accounting policies for the State but does not have the statutory authority to monitor adherence to these policies as performed by State agencies.

In accordance with the Fiscal Control and State Internal Auditing Act, each State agency's Chief Executive Officer maintains statutory responsibility for the establishment and continuous monitoring of the internal control function for accounting and other operating policies of the Officer's agency. (Finding Code No.10-2, 09-1, 08-1, 07-1, 06-1, 05-1, 04-1, 03-1, 02-1)

RECOMMENDATION

We recommend the State implement additional internal control procedures in order to assess the risk of material misstatements to the financial statements and to identify such misstatements during the financial statement preparation process. The internal control procedures should include a formal evaluation of prior problems and implementation of procedures to reduce the risk of these problems reoccurring.

AGENCY RESPONSES

Office of the Governor:

The Governor's Office agrees with this finding. The response to finding 10-1 is also applicable here. If the State had an entity-wide financial reporting system, internal controls would be in place to lessen the risk that statements are not accurately presented. Controls would be built into the system to detect any deficiencies that could result in a material weakness or a significant deficiency.

Office of the State Comptroller:

The IOC will assist the Governor's Office in their efforts to increase the quality of the GAAP packages by providing training and technical advice to State agencies.

10-3. **FINDING** (Late Payment of Statutorily Mandated Transfers)

The Office of the Comptroller (Comptroller) did not make all statutorily mandated transfers from the General Revenue Fund within established timeframes, as required.

The Comptroller had a system in place to identify and record inter-fund transfers it was required to make. During the fiscal year ended June 30, 2010, the Comptroller timely recorded within the Statewide Accounting Management System (SAMS) the receivables and related payables for transfers of money in the State Treasury to be made between State of Illinois' funds. However, not all transfers were made timely. During fiscal year 2010, we noted 289 transfers from the General Revenue Fund to various other funds that were made greater than 30 days after the statutorily mandated transfer date. Transfers that were made between one and 30 days after the statutorily mandated transfer date were excluded from the information provided in this finding. The following summary concerning late payment of statutorily mandated transfers from the General Revenue Fund highlights the increase in delays of making such transfers in fiscal year 2010 compared to fiscal year 2009:

	Fiscal Year 2010	Fiscal Year 2009
• Number of late transfers	289 transfers	223 transfers
• Range of days transfers were late	31 to 525 days	31 to 203 days
• Total volume of late transfers, in dollars	$2.0 billion	$1.5 billion
• Late transfers outstanding at June 30, paid during lapse period*	$941.8 million	$184.6 million

* (Lapse period for fiscal year 2010 was from July 1 through December 31. For fiscal year 2009, lapse period was from July 1 through August 31.)

Comptroller management stated that the late payment of transfers occurred because of cash management decisions and prioritization that was required due to the lack of available cash in the State Treasury.

Failure to make inter-fund transfers within applicable timeframes represents noncompliance with State law, and untimely transfers of monies may have delayed the receiving fund's use of appropriated funds. (Finding Code No. 10-3, 09-3)

RECOMMENDATION

We recommend the Office of the Comptroller make transfers within timeframes established by applicable statute. While we realize that lack of available funds in the State Treasury requires prioritization and cash management decisions, we recommend the Office of the Comptroller continue in its efforts to make transfers in as timely manner as possible.

AGENCY RESPONSE

Office of the Comptroller:

The Office will continue in its efforts to make transfers in as timely manner as possible.

10-4. **FINDING** (Noncompliance with General Obligation Financing Provisions)

Pursuant to Public Act 96-0044, the Office of the Comptroller (Comptroller) transferred general obligation bond proceeds from the Coal Development Fund for general operating expenses of the State of Illinois (State). The transfer of the bond proceeds for operating expenses of the State represents noncompliance with the terms of the bond sale order related to the issuance of State of Illinois general obligation bonds.

As authorized by the General Obligation Bond Act (Bond Act) (30 ILCS 330/7) the State issued general obligation bonds to provide funds for coal and energy development as well as certain other capital purposes. During fiscal year 2010, the State issued general obligation bonds including one issuance totaling $400 million. Pursuant to the Bond Act and the terms of the bond issuance, $20.7 million bond proceeds from this sale was deposited into the Coal Development Fund. During fiscal year 2010, the Comptroller executed quarterly transfers totaling $320 thousand paid from the Coal Development Fund to the General Revenue Fund for operating expenses of the State pursuant to Public Act 96-44.

Section 6 (f) (1) and (2) of the State's *General Obligation Bonds, Series A of September, 2009*, bond sale order states that the portion of the bond proceeds sold for coal development financing are to be deposited in the Coal Development Fund and used for the following purposes specified in the Bond Act (30 ILCS 330/7 (d) and (e)) : 1) to provide financial assistance to certain new electric generating facilities, 2) for the purpose of facility cost reports prepared for not more than one clean coal facility and one clean coal SNG (synthetic natural gas) facility, and 3) development costs pursuant to the Illinois Coal Resurgence Program. Neither the terms delineated in the bond sale nor the Bond Act provide for the use of the bond proceeds for purposes other than stated above, with the exception that the bond sale order allows that payment of the costs of issuance and sale of the bonds may be made from the proceeds. However, the terms of the bond require that if proceeds are used for payment of issuance costs, the amount for each purpose for which the bonds were issued must be ratably adjusted, and in no event shall salaries of State employees or other State office operating expenses be paid out of non-appropriated proceeds (Section 6 (g) of the bond sale order).

The Comptroller made the above described transfers pursuant to the mandate from Public Act 96-0044 which directed these, and other transfers be made "in order to maintain the integrity of special funds and improve stability in the General Revenue Fund" and that the transfers should be made "notwithstanding any other provision of State law to the contrary" (30 ILCS 105/8.49 (a)). Public Act 96-44 allowed for the return of money transferred from the Coal Development Fund, and other funds, only in the event that the fund was unable to expend appropriated amounts as a result of insufficient cash balances. Comptroller staff stated that they contacted the Governor's Office of Management and Budget before the transfers were completed and discussed seeking authority to initiate a transfer reversal. The Comptroller also footnoted the transfer on its monthly bond report.

Use of bond proceeds for purposes not in compliance with and authorized by the Bond Act and the terms of the debt issuance could result in accelerated repayment if required by the bondholders and could also jeopardize the State's ability to obtain future financing. (Finding Code No. 10-4)

RECOMMENDATION

We recommend that the Office of the Comptroller coordinate with the Director of the Governor's Office of Management and Budget regarding possible resolutions to the transfers made to the General Revenue Fund, and if necessary, seek a formal opinion from the Attorney General.

AGENCY RESPONSE

Office of the Governor:

The Governor's Office agrees that this transfer presents noncompliance with the terms of the bond sale. The transfer was included in SB1433 as passed by the General Assembly May 31, 2009, and signed into law as Public Act 96-0044. Signing this bill was necessary to implementing the 2010 budget. Once this became law, the Comptroller's Office was required to initiate the transfer. Funds cannot be transferred back to the fund without legislation authorizing the transfer from the General Revenue Fund to the Coal Development Fund. Despite attempts by GOMB, the General Assembly has not been able to pass such legislation. GOMB will continue to urge the General Assembly to pass legislation allowing the funds to be repaid to the Coal Development Fund.

Office of the Comptroller:

The Office will work with Governor's Office of Management and Budget, and if necessary, consult with the Attorney General regarding resolution of this matter.

10-5. **FINDING** (Weaknesses Identified in the Securities Lending Program)

During testing of the Illinois Office of the Treasurer’s (Office) securities lending program, auditors identified a number of weaknesses.

The Deposit of State Moneys Act (Act) (15 ILCS 520/22.5) allows the Treasurer, with approval of the Governor, to lend any securities acquired under the Act. The Act also sets forth that securities lent must be done in accordance with Federal Financial Institution Examination Council guidelines. At June 30, 2010 the Office had $3,095,533,634 of securities on loan. The auditors identified the following issues while testing the Office’s securities lending program:

- The Office has not developed written policies and procedures covering each of the requirements listed in the Federal Financial Institution Examination Council (FFIEC) guidelines for securities lending as required by FFIEC guidelines.

- Periodic internal audits have not been performed covering all internal audit requirements outlined in the FFIEC guidelines for securities lending.

- The Office could not provide documentation of approval from the Governor to lend securities as required by the Act.

- The Officer has not created a specific investment policy for the governance of securities lending as set forth in the Office’s Investment Policy.

- 8 of 33 (24%) daily securities lending reports tested were not reviewed by Office personnel.

- 1 of 33 (3%) daily securities lending reports tested did not contain adequate notations to support review by Office personnel.

- 2 of 33 (6%) daily securities lending reconciliations were approved by a Banking Division Supervisor 7 and 9 business days after they were completed. The Office strives to complete their reviews on a daily basis.

The Illinois State Treasurer’s Investment Policy, section 5.0 (m), indicates securities in the Office’s portfolio be lent in accordance with “an investment policy created for the governance of Securities Lending.” The Office’s internal controls include daily preparation, review, and approval of various securities lending program reports and reconciliations.

The Office’s personnel attributed the issues to a different interpretation of the Deposit of State Moneys Act and the Illinois State Treasurer’s Investment Policy.

Without a documented securities lending policy, the Office's securities lending program may not be functioning in accordance with the Federal Financial Institution Examination Council guidelines as required by the Act. Not following Office internal control procedures to perform and, or document performance and approval of required reviews identifies a weakness of the Offices control environment in the securities lending program. In addition, failure to comply with mandated responsibilities is noncompliance with statutory requirements and does not fulfill the legislative intent of the Act. (Finding Code No. 10-5)

RECOMMENDATION

We recommend the Office strengthen its internal controls over the securities lending program to ensure daily securities lending reports and investment reconciliations are reviewed timely and adequately. In addition, the Office should develop written policies and procedures to ensure compliance with the FFIEC guidelines and the Fiscal Officer Investment Policy. Lastly, the Office should ensure adequate internal audits are performed over the securities lending program.

AGENCY RESPONSE

Office of the Treasurer:

The Treasurer agrees with the finding and recommendation.

1. The Treasurer's Office Banking Division completed written policies and procedures in December 2010. During the analysis and preparation of the procedures, it was believed the division was complying in general with the FFIEC guidelines.

2. An internal audit of the securities lending function is being performed.

3. The Illinois Constitution, Article V, Section 18, states that the Treasurer has the duty to be responsible for the "safe-keeping and investment of monies and securities deposited with him."

   The Treasurer sends a monthly report to the Governor on activities including investments of all types, as well as fund balances. In addition, the Treasurer's web site http://www.treasurer.il.gov/finances/schedule-of-investments.aspx is updated weekly, and contains all information on weekly investments.

   The State Treasurer is an independent officer of the Executive branch of Illinois Government. The Constitution created six distinct offices with six separate sets of responsibilities. This sets up a clear set of checks and balances within the Executive Branch, as well, as the checks and balances inherent in the three distinct branches of Government, also created by the Constitution, Executive, Legislative and Judicial.

State law cannot simply restrict or put limitations on a duty that is granted by the Constitution. It also cannot subject one duly elected Official, the Treasurer, to asking another elected Official, the Governor, for permission to do what is constitutionally his duty.

The State Treasurer's Office will work with the legislature and the Governor's Office to statutorily correct this situation.

4. Office personnel submitted a proposal to the Treasurer's internal investment policy committee to remove Section 5.0 (m) requiring an investment policy be created for the governance of Securities Lending.

5. and 6. During the past fiscal audits, it has become evident that an increased emphasis is being placed on the securities lending program. The focus of the audits has changed from an accounting and investment income perspective to compliance and regulatory guidelines with a concentration on daily review and signature by management. It has not been our past experience to be required to produce securities lending reports which evidence management review. From the inception of the program, office personnel have visually reviewed various reports for compliance. The office has continued to modify and enhance the reports, the investment system and related procedures to ensure compliance with the contract and accounting standards. As of July 1, 2010, all reports pursuant to the policy and procedure guidelines are printed, reviewed and management signatures and dates are applied. The Treasurer's Office makes every effort to review the reports within a reasonable time period.

7. During the past fiscal year, the office has strengthened internal controls and enhanced reporting in the Treasurer's investment system to provide a more streamlined approach to the reconciliation process. The Treasurer's Office makes every effort to review the reports within a reasonable time period. Any discrepancies found by staff accountants are immediately brought to the supervisors attention for review and resolution.

10-6. **FINDING** (Debt Covenant Violation)

The Illinois Student Assistance Commission (Illinois Designated Account Purchase Program) was not in compliance with one of the covenants relating to the agency's revolving line of credit agreement.

During the audit of the agency's June 30, 2009 financial statements, the Illinois Designated Account Purchase Program (IDAPP) management brought to our attention that they had violated one of the covenants relating to the agency's revolving credit line (loan) agreement with a bank. The non-compliance pertained to the "Coverage condition ratio" covenant. According to the line of credit agreement with the bank, the "Forbearance Excess Amount", defined as the aggregate value of all eligible student loans that are subject to forbearance, is to be used in the calculation of the Coverage condition ratio covenant. When IDAPP completed the report, created by the bank, as instructed by the bank, the report produced an inaccurate calculation of the amount for the loans in forbearance. Once the error was discovered and the Coverage condition ratio was recalculated, it resulted in a lack of compliance with the Coverage condition ratio by IDAPP.

During our audit of the agency's June 30, 2010 financial statements, we noted that the IDAPP continued to be in violation of the same covenant noted above. However, we noted that IDAPP had improved internal controls related to reporting requirements of the various indentures. IDAPP has a master checklist that incorporates all reporting requirements of the various indentures. The checklist is monitored and maintained on a monthly basis. All of the reporting requirements are reviewed and signed-off by management.

As a result of the violation, the bank has certain remedies available to it under the terms of the loan agreement, principal of which would be rights to call the loan and take possession of the collateral (the underlying student loan portfolio). The bank has been made aware of the event of default and has not communicated to IDAPP any intent to exercise the remedies available to it under the terms of the loan agreement. Management believes the bank would have little incentive to call the line of credit and begin servicing the student loans itself, particularly because IDAPP has made all of its required payments in a timely fashion. The balance of the line of credit with the bank was $355,456,827 at June 30, 2010. According to ISAC management, the bank has agreed to refrain from exercising their rights under the Agreement until July 27, 2011.

The debt covenant violation with the bank also triggered a default in one of the covenants in the loan agreement with another bank. This bank granted IDAPP a deferment from exercising its rights in connection with such default until July 31, 2010. Shortly thereafter, the bank was taken over by the FDIC. Since that time, IDAPP has been pursuing an agreement with the new institution for an extension on the July 31, 2010 deferment date. This issue has not yet been resolved. The balance in the line of credit with this bank was $4,717,675 at June 30, 2010.

According to IDAPP management, the cause of the Coverage Condition breach was due to the level of forbearances exceeding the limit. This was due to the policy of treating student borrowers who had both loans guaranteed by the Federal Family Education Loan Program (FFELP) and other loans not guaranteed by FFELP as if all its loans were guaranteed by FFELP.

Failure to comply with debt covenants could result in the debt becoming due and payable in advance of scheduled retirement dates. As a result of the violation, both banks may have certain remedies under the terms of the loan agreements, principal of which would be the right to call the loans and take possession of the collateral (the underlying student loan portfolio of IDAPP). (Finding Code Nos. 10-6, 09-3)

RECOMMENDATION

We recommend that IDAPP continue to monitor these loan covenant violations and continue seeking remedies from the lenders involved.

AGENCY RESPONSE

The Governor’s Office recognizes that the Illinois Student Assistance Commission violated a loan covenant and will see that IDAPP continues to monitor these loan covenants. The Governor’s Office will also monitor management to assure the Commission is in communication with both parties and is working with them to resolve the violations.

10-7. **FINDING** (Finances Increase Risks)

The State of Illinois did not have sufficient controls over its finances to ensure obligations are paid timely and funds are used for their original intended purpose. This condition increases the risk that liabilities will not be properly recorded and funds will be used in a manner that violates agreements with outside parties. This condition also diminishes the usefulness of the fund financial statements. We noted the following during our financial audit of the State's financial statements and our financial audits at various Departments.

As disclosed in the Footnote 22.b, the State had transactions, totaling $5.281 billion, on hand at June 30, 2010 that had been approved for payment by the State, but remained unpaid at year end due to the State's cash flow difficulties. Of this amount, nearly $4 billion was owed to external parties, the remaining balance was related to intra-governmental transactions. The external parties include State vendors, State Universities, local schools and local governments. The majority of these "held-payments" were payable from the General Revenue Fund. This condition was the underlying cause for the $525 million accounting error reported in finding 10-2 for the Department of Healthcare and Family Services.

The State's inadequate financial reporting process as described in Finding 10-1 was designed in 1981 under the assumption that cash payments would be made at the time the expenditures were processed by the Comptroller. Since this was not the case at year-end, extra effort was required by the accountants and the auditors to ensure the "held-payments" were appropriately accounted for.

During our audit of the Illinois Department of Revenue (IDOR), the auditors reported that there was a deficit balance in the Income Tax Refund Fund (Fund 278), a sub account of the General Revenue Fund, because the State did not allocate sufficient income tax revenues into Fund 278. Under the Illinois Income Tax Act (35 ILCS 5/901), the portion of the income tax receipts deposited into Fund 278 is a formula based percentage (referred to as the "Rate as Certified" in the table below) only when a different rate is not defined in Statute (referred to as the "Rate per Statute" in the table below). A comparison of the "Rate per Statute" and the "Rate as Certified" since fiscal year 2000 is as follows:

	Individual Income Tax (IIT)		Business Income Tax (BIT)		278 Fund -
State Fiscal	Rate per	Rate as	Rate per	Rate as	Fund Balance
Year	Statute	Certified	Statute	Certified	(Deficit), in thousands
2002	7.60%	7.60%	23.00%	23.00%	$ (1,091,619)
2003	8.00%	8.00%	27.00%	27.00%	(1,308,642)
2004	11.70%	11.70%	32.00%	32.00%	(745,086)
2005	10.00%	11.20%	24.00%	36.80%	(530,317)
2006	9.75%	*	20.00%	*	(622,628)
2007	9.75%	*	17.50%	*	(731,784)
2008	7.75%	*	15.50%	*	(854,829)
2009	9.75%	9.62%	17.50%	8.75%	(949,386)
2010	9.75%	11.99%	17.50%	17.14%	(1,380,161)
2011	8.75%	14.60%	17.50%	26.00%	not available

* In the table above, the "Rate per Statute" was enacted prior to June 30th for the following fiscal years 2006, 2007, and 2008. As such, there was no formula based rate calculation performed ("Rate as Certified").

As can be seen from the table, the amounts deposited in the 278 Fund for 2002 through 2004 were based on the "Rate as Certified", and the 278 Fund deficit was reduced over those years. Since that time, the "Rate as Certified" has been overridden and the deficit has been gradually increasing. The underfunding of the 278 Fund is the major contributor to the significant deficit that has accumulated in this fund through June 30, 2010.

Large deficits in the Income Tax Refund Fund indicate that the State is essentially borrowing from taxpayers (individuals and businesses) since overpayments of taxes are not revenue to the State when accounted for in accordance with generally accepted accounting principles (GAAP). Delays in paying tax refunds generates additional adjustments to convert cash basis amounts to GAAP basis. These necessary adjustments, due to lack of cash payment, increases the risk that liabilities will not be recognized in the proper period.

Pursuant to Public Act 96-44 (Act) $356 million was transferred out of other funds and into the General Revenue Fund during fiscal year 2010 in order to improve stability of the General Revenue Fund. According to the Act, the transfers shall be made notwithstanding any other provision of State law to the contrary. The following table details by fund type the total transfers out made for this purpose.

Fund Type	Number of Funds	Total Transfers Out
Special Revenue	181	$ 304,843,502
General	8	$ 29,745,061
Internal Service	3	$ 15,922,190
Agency	2	$ 659,000
Enterprise	3	$ 3,795,520
Private Purpose Trust	1	$ 503,700
Capital Projects	1	$ 320,000
Permanent Trust	1	$ 250,000
Total	**200**	**$ 356,038,973**

Special Revenue Funds account for resources obtained from specific revenue sources that were originally restricted to expenditures for specified purposes. There have been several legal cases filed against the State that challenge the constitutionality of legislation that allowed the broader use of fee proceeds that are deposited into special funds.

General use of resources originally designated as Capital Projects, Permanent Trust, Private Purpose Trust, Agency, and Enterprise increases the risk that covenants with outside parties will be violated. As reported in Finding 10-4, Public Act 96-44 may have caused this type of violation during fiscal year 2010 related to the General Obligation Financing Provisions.

Economic conditions as well as years of unbalanced budgets appear to be the cause of above conditions.

Sound business practices require sufficient controls to ensure liabilities are paid timely and funds are used for the purpose for which they were originally obtained. (Finding Code No. 10-7)

RECOMMENDATION

We recommend the Governor work with the General Assembly to improve the State's control over State finances in a manner that eliminates significant payment delays including refunds due to taxpayers.

We also recommend that the Governor work with the General Assembly to ensure fund transfers are made in conformity with law and other applicable governing agreements.

AGENCY RESPONSE

The Governor's Office recognizes that significant balances are owed at year-end but does not feel that this is the result of the administration's insufficient controls over its finances. These unpaid bills are the result of the economic downturn and diminished revenues. That these unpaid bills create a risk that liabilities are unrecorded is the result of finding 10-1. If the State had a consolidated accounting system with a general ledger, these liabilities could be properly recorded. The Governor's Office and the GOMB are aware of the unpaid obligations and sought to have a debt restructuring passed by the General Assembly that would have allowed these liabilities to be consolidated in one easily identifiable debt. Besides the accounts payable, the proceeds would have been used to repay outstanding tax refunds. The Governor's Office and GOMB agree that the refund rate is insufficient to pay tax refunds and will work with the General Assembly to pay these outstanding refunds by recommending refund rates that are sufficient to pay refunds in the year they are due.

Public Act 96-0044 required transfers to be made from other state funds to the General Revenue Fund. The Governor's Office is not aware of legal challenges to any of these transfers. Except the transfer from the fund mentioned in finding 10-4 that GOMB has been trying to correct, the Governor's Office is unaware of any transfers violating covenants with outside parties. This type of inter-fund transfer has not been in any legislation since FY 2010.

AUDITORS' COMMENT

The material weakness related to the inadequate accounting system as identified in finding 10-1 has been reported by the auditors the last four audits. The unprecedented amount of held payments of $5.281 billion at the end of FY10 created an additional risk that material liabilities would not be recorded in the proper period. Auditing standards require the auditor to report such risks as material weaknesses to those charged with governance. The held payments had legal authorization for payment and were unpaid due to a lack of resources. Attributing the cause of this additional weakness to a lack of control over State finances is reasonable since the State essentially follows a cash basis budget process. As noted in the finding, we do agree that economic conditions are relevant to the cause of the condition.

The Governor's Office notes that no legal challenges have been made for the FY10 transfers. As we reported in the finding, challenges have occurred in the past. The classification of funds as Agency, Private Purpose Trust, and Permanent Trust indicates a degree of fiduciary responsibility for the State. Simply being "unaware" of a covenant violation does not eliminate the audit concern that such transfers did or could violate covenants with outside parties. We continue to recommend that the Governor work with the General Assembly to ensure fund transfers are made in conformity with law and other applicable governing agreements.

10-8. **FINDING** (Weaknesses in Compilation Process)

The Office of the Comptroller's process for compiling the Comprehensive Annual Financial Report (CAFR) lacked adequate internal controls. We noted the following control deficiencies during our audit:

- One person has the primary responsibility for implementing new accounting standards, addressing accounting issues with individual agencies, and managing the compilation of the CAFR.
- There was no formal process for a documented review of all CAFR components by a person independent of the preparer.
- There was no formal process that all financial journal entries posted by the Comptroller's staff have a documented review by a person independent of the person that initiates them.
- There has been no internal audit work related to the CAFR financial reporting process in the past four years.

The Fiscal Control and Internal Auditing Act (30 ILCS 10/3001) requires State agencies to establish and maintain a system of internal fiscal and administrative controls which provides assurance that revenues, expenditures, and transfers of assets, resources, or funds applicable to operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the State's resources. The Act also requires the chief executive officer to ensure the internal auditing program includes an audit of major systems of internal accounting and administrative control conducted on a periodic basis so that all major systems are reviewed at least once every two years (30 ILCS 10/2003).

Good internal controls would require that no one individual should control all key aspects of a transaction or event. Duties and responsibilities should be assigned systematically to a number of individuals to ensure that effective checks and balances are in place and routinely practiced. (SAMS Procedure 2.50.10)

Over reliance on one individual for the financial reporting process subjects the State to potential serious disruption in the event that there are changes to that individual's employment status. Lack of independent reviews leaves the compilation process open to risks of erroneous or fraudulent financial reporting. Internal audits are an essential monitoring process to enable management to determine whether components of internal control over financial reporting continue to function over time.

In discussing these conditions with IOC management, they indicated turnover of key management personnel in the Financial Reporting section during the current fiscal year

CAFR compilation process reduced the IOC's ability to prepare the CAFR with the desired level of segregation of duties. (Finding Code No. 10-8, 09-4)

RECOMMENDATION

We recommend the Office of the Comptroller allocate sufficient, competent resources to the financial reporting function in order to reduce reliance on key personnel and provide adequate segregation of duties. We also recommend the Office ensure the internal audit program includes an audit of the CAFR reporting process at least every two years.

AGENCY REPSONSE

Office of the Comptroller:

During the CAFR compilation process for fiscal year 2010, steps were taken to enhance the review procedures of the CAFR reporting process. The IOC has taken steps to hire additional personnel for the Financial Reporting section, which will enhance the level of segregation of duties. The IOC will continue to work on developing a formal process for a documented review of all CAFR components.

During May 2011, IOC's Internal Audit Department initiated an internal audit of the CAFR reporting process. This review will include the implementation of the newly developed WEDGE system changes.